

# **Tax Restructuring Proposal FY 2008 Budget**

House Tax Policy  
Committee

Robert J. Kleine  
State Treasurer  
February 21, 2007

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## **Topics Covered**

- Revenue picture
- Tax cuts of the 1990s
- MBT changes
- Additional elements of tax proposal

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## Total State Expenditures

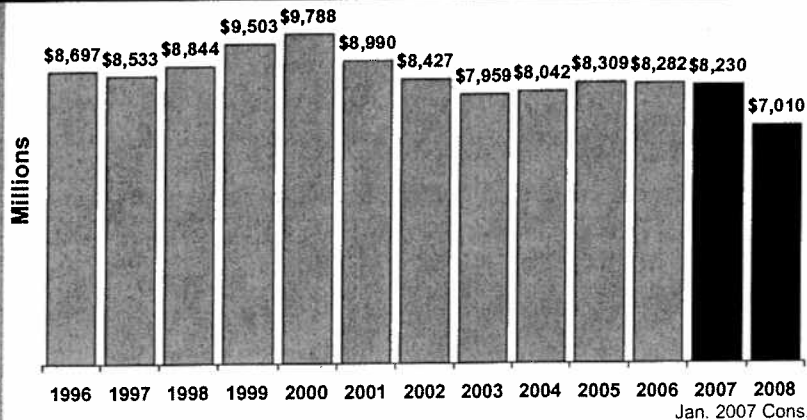
Fiscal Year	Total Expend.	Fed. Aid	Transp.	School Aid	Other Restricted	GF-GP
2001	\$36,953.3	\$10,002.2	\$2,046.7	\$10,401.7	\$4,758.3	\$9,744.4
2006	\$41,264.3	\$12,885.4	\$2,184.1	\$11,682.5	\$5,455.7	\$9,056.6
% Change	12%	29%	7%	12%	15%	-7%
Infl Adj. % Chg.*	-9%	4%	-13%	-9%	-7%	-25%

\*Inflation adjustment done using state and local government price deflator.

Source: State Budget Update, Jan 2007, and Various Appropriation Reports, Senate Fiscal Agency

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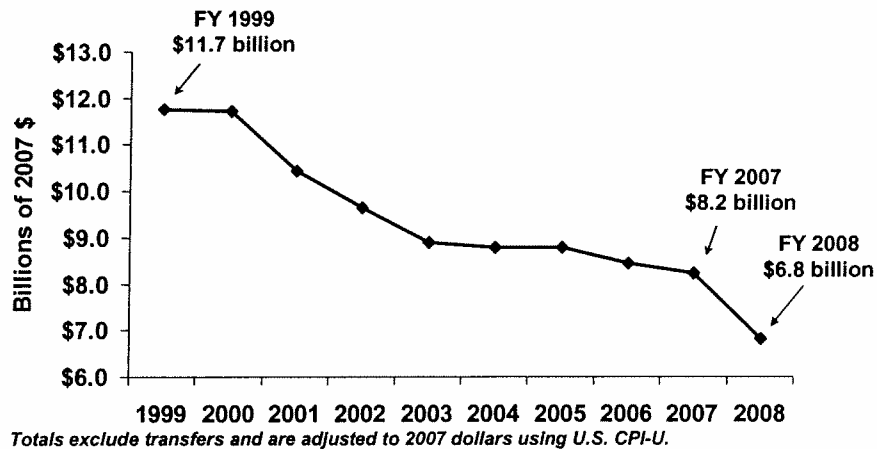
## Nominal General Fund Net Revenue in 2007 Less Than in 1996



Note: Totals exclude transfers and savings from adjusting statutory revenue sharing payments to local governments. 2008 drops due to SBT repeal.

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## Inflation Adjusted FY 07 GF-GP Revenues Down 29 Percent Since FY 99



## Revenue at Extreme Historic Lows

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Fiscal Year	Governor	Inflation Adj GF Revenue (2006\$)	% Above 2006
1973	Milliken	\$11,820	43%
1978	Milliken	\$12,129	47%
1989	Blanchard	\$11,649	41%
1999	Engler	\$11,518	39%
2000	Engler	\$11,496	39%
2006	Granholm	\$8,267	

## GF-GP Expenditures Fall

<u>Fiscal Year</u>	<u>Actual</u>	<u>FY 2001 Grown by S&amp;L Deflator</u>
2001	\$9,744.4	\$9,744.4
2002	\$9,189.3	\$9,953.8
2003	\$8,830.9	\$10,343.9
2004	\$8,770.1	\$10,734.1
2005	\$8,702.8	\$11,381.2
2006	\$9,056.6	\$12,018.7

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Source: State Budget Update, Senate Fiscal Agency, January 2007.

## State Government is Smaller

<u>Fiscal Year</u>	<u>Governor</u>	<u>Number State Employees</u>	<u>Non-Corrections State Employees</u>	<u>Corrections Employees</u>
1973	Milliken	52,673	50,316	2,357
1978	Milliken	64,456	59,990	4,466
1989	Blanchard	64,560	52,038	12,522
1999	Engler	60,066	43,003	17,063
2000	Engler	61,493	43,841	17,652
2006	Granholm	52,259	35,813	16,446
% Change 1978-2006		-19%	-40%	268%
% Change 2000-2006		-15%	-18%	-7%

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## Government Not Large Compared to Other States

State and Local Govt. Employees Per 10,000 of Population		
State		Rank
Ohio	544	27
Minnesota	539	31
Indiana	528	35
Wisconsin	521	37
Illinois	500	43
<b>Michigan</b>	<b>499</b>	<b>44</b>
U.S. Average	538	

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Source: CQ's State Fact Finder 2006.

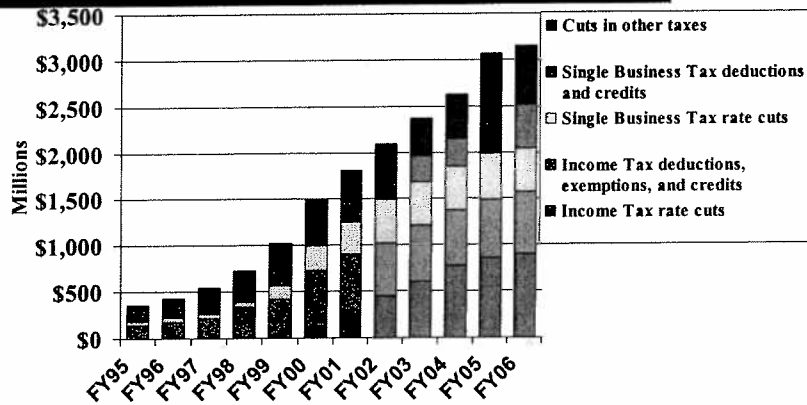
## State Government is Well Run

State	Grade	Rank
Virginia	A-	1
Utah	A-	1
Michigan	B+	3
Minnesota	B+	3
Delaware	B+	3
Kentucky	B+	3
Washington	B+	3
Ohio	B	8
Wisconsin	B-	21
Indiana	C+	30
Illinois	C+	30

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Source: Governing Magazine

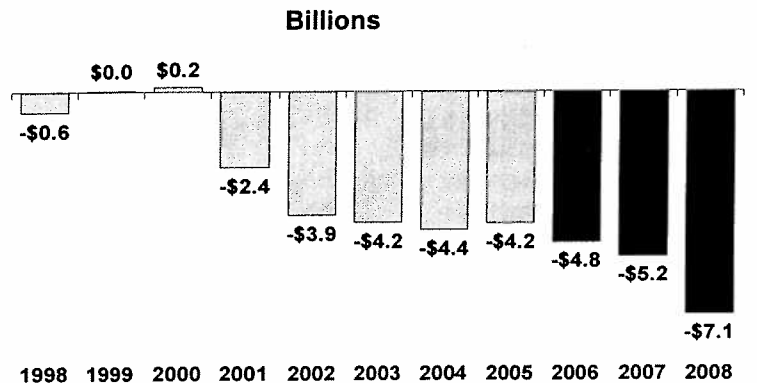
## Tax Cuts Since Proposal A Total \$3.2 Billion in FY 2006



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Note: Totals above are tax cuts only and do not include the effects of the gasoline, casino, and cigarette tax increases which generate \$870 million per year

## Constitutional Revenue Limit Calculation



January 2007 Consensus

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## Elements of the Plan

- MBT with changes suggested by business community
- 2% tax on services excluding education and healthcare
- Federally decoupled estate tax applicable to 350 estates a year worth more than \$2 million
- Increase in OTP and \$0.05 cigarette tax increase
- Increase in liquor markup
- Elimination of certain loopholes
- Sales tax break for car buyers based on the value of a car traded in for a new vehicle

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## Effects of Tax Changes

- Plan will recapture about 1/3 of tax cuts of last decade
- Michigan's business and overall tax burdens will remain below the national average
- The replacement for the SBT will make Michigan a more attractive place for businesses
- Makes Michigan's tax structure more responsive to economic growth
- Allows us to invest in education and healthcare to make Michigan more attractive for businesses and our citizens

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## Michigan Business Tax

- Tax base consists of sales, assets, and income
- Broad base allows for rate of 0.125 percent on sales and assets – the lowest rate in the country!
- Tax rate on profits just 1.875 percent, well below any other state's corporate income tax rate<sup>1</sup>
- Includes special features for small businesses
- Provides personal property tax relief

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1. Alaska and Arkansas have corporate rates that start at 1 percent but have substantially higher top corporate rates.

## Changes to the MBT

- Change definition of financial organizations
- Subtract sales of intangible assets from gross receipts
- Eliminate double taxation of corporate partnerships
- Subtract inter-company sales among affiliates from gross receipts
- Exclude foreign assets and tax deferred assets from the base
- Provide a credit for high paying jobs provided at corporate headquarters

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## **MBT Cuts State's Major Business Tax**

- Headquarters credit reduces taxes by \$240 million
- Other changes reduce the MBT by an additional \$240 million so the MBT raises \$480 million less than the SBT would
- \$578 Million tax cut for Michigan businesses
- \$250 million tax cut for small businesses
- 111,000 firms pay less MBT than SBT while 33,000 firms pay more

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## **Personal Property Tax Relief**

- Industrial and commercial personal property will be exempt from the 6 mill state education tax and the 18 mill local school operating tax
- The exemption amounts to an average reduction of 46 percent in personal property taxes
- This change does not affect city, township, or county taxes
- Cut lowers personal property taxes by over \$600 million per year

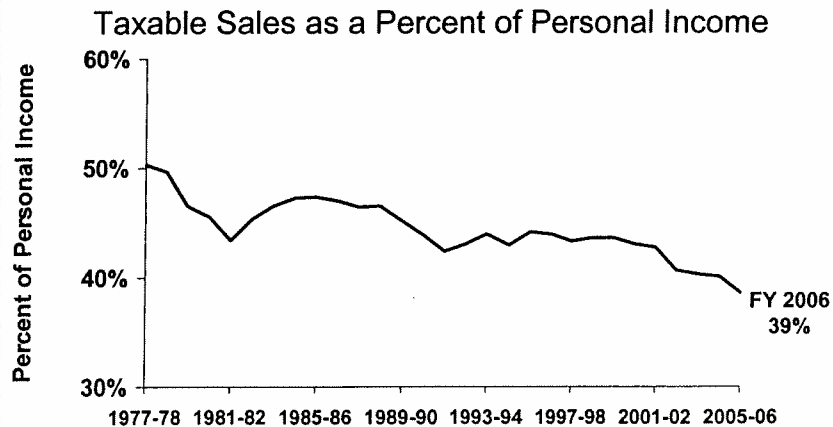
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## MBT Cuts for Service Businesses

<u>Service Category</u>	<u>% Tax Reduction</u>	<u>% Paying Less</u>
Accounting Services	-50.8%	93.6%
Legal Services	-66.0%	91.3%
Auto Repair Shops	-63.3%	91.4%
Dry Cleaning	-67.4%	89.9%
Engineering/Architectural	-69.8%	91.3%
Total For All Services	-33.2%	83.0%

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## Sales Tax Share Declining



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## State Taxation of Services

- Based on a survey by the Federation of Tax Administrators, Michigan currently taxes 26 out of 168 services
- Michigan ranks 39<sup>th</sup> highest
- On average, states tax 55 services, more than twice as many as Michigan

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## State Taxation of Services

State	Number of Services Taxed	Rank
Hawaii	160	1
Washington	157	2
New Mexico	156	3
South Dakota	146	4
Delaware	143	5
Wisconsin	74	11
Ohio	68	16
Minnesota	67	17
<b>Michigan (current law)</b>	<b>26</b>	<b>39</b>
Indiana	23	41
Illinois	17	46

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Source: Federation of Tax Administrators

## **Taxing Services**

- Proposing a 2 cent tax on services beginning June 1
- Tax base would include professional entertainment, repair and maintenance services, construction services, legal and accounting, and personal care

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## **Exempt Services**

- Some services excluded from tax are
  - Healthcare and education
  - Daycare
  - Religious services
  - Sales to non-profits and governments
  - Services provided for agricultural production
  - High school and college sports admissions
  - Museums, historical sites, zoos, and parks
  - Scientific research and development

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## Many States Tax Services

These Items are Currently Exempt in Michigan

<u>Service</u>	<u>Number of States Taxing</u>
Landscaping	21
Auto Repair	23
Dry Cleaning	24
Health Clubs	22
Installation*	24
Shoe repair	21

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\*Installation by seller of item, 19 states tax installation by non-sellers

## Many States Tax Admissions and Amusements

These categories would be taxable under the service tax  
Number of states taxing in parentheses

- Professional sports (22)
- Pari-mutuel racing (29)
- Bowling alleys (28)
- Circuses/fairs (35)
- Cultural events (theater, concerts) (34)
- Amusement parks (38)
- Cable/satellite TV (26)
- Billiard parlors (28)
- Membership dues (24)

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## Examples

1. \$25 pedicure – cost with tax \$25.50
2. \$35 greens fees for golf – cost with tax \$35.70
3. \$100 theater tickets – cost with tax \$102.00
4. \$250 labor charge on repair bill – cost with tax \$255.00
5. \$5,000 consulting bill – cost with tax \$5,100

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## Sales Tax on the Difference

- Allows trade-in allowance to be deducted from price of new car when calculating sales tax starting October 1
- Change would bring Michigan's practice in line with most other states
- Tax reduction of \$180 million per year

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## Taxpayer Example

	Income = \$57,300	
	Basic Example	More Complex Example
Est. Sales Tax	\$1,087	\$1,087
Est. New Service Tax & Loopholes	\$69	\$69
Total Tax Including Services	\$1,156	\$1,156
Estimated Tax Increase	\$69	\$69
\$25k Home Renovation - Sales Tax	NA	\$623
\$25k Home Renovation - Service tax	NA	\$292
Total Estimated Tax Increase	\$69	\$361
Vehicle Trade-in (\$10,550 avg)	NA	-633
Total Estimated Tax Increase	\$69	-\$272

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## Estate Tax Decoupling

- Federal law changes made in 2001 effectively ended Michigan's estate tax
- "Decouple" proposal would base Michigan's tax on 2001 federal law
- 18 states and the District of Columbia have decoupled
- No tax for estates valued less than \$2 million
- Assets attributable to family owned businesses and farms exempt
- Effective rates after federal deductibility close to 5%

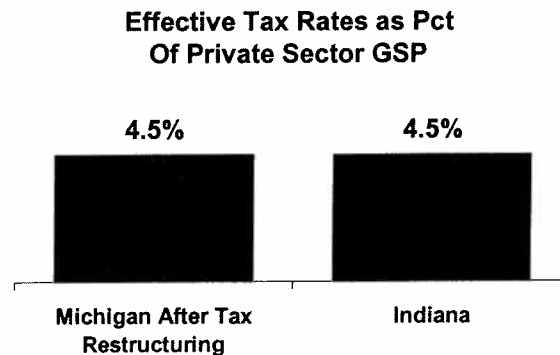
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## Tax Burden After Changes

- Michigan state and local business taxes as a percent of GSP will be 4.5% compared to U.S. average of 4.8%
- Michigan's total state and local tax burden will be 10.66% of personal income compared to a national average of 10.75%

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## Michigan's Business Tax Burden Will Be the Same as Indiana's



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Source: COST Analysis, with Michigan after restructuring calculated  
By the Michigan Department of Treasury



## Overall Balance Sheet

	<u>CY 2007</u>	<u>CY 2008</u>	<u>CY 2009</u>	<u>CY 2010</u>
Net Effect SBT Replacement	\$0.0	(\$457.7)	(\$468.6)	(\$467.4)
Service Tax	\$845.5	\$1,484.6	\$1,529.2	\$1,575.0
Loopholes & Other Increases	\$95.1	\$190.2	\$194.3	\$198.6
Estate Tax	\$29.8	\$120.1	\$134.9	\$138.9
Sales Tax on Difference	(\$43.8)	(\$176.3)	(\$181.6)	(\$187.0)
<b>Net Effect Restructuring</b>	<b>\$926.6</b>	<b>\$1,160.9</b>	<b>\$1,208.2</b>	<b>\$1,258.1</b>
EITC	\$0.0	\$0.0	(\$127.9)	(\$283.6)
Net Revenue with EITC	\$926.6	\$1,160.9	\$1,080.3	\$974.5

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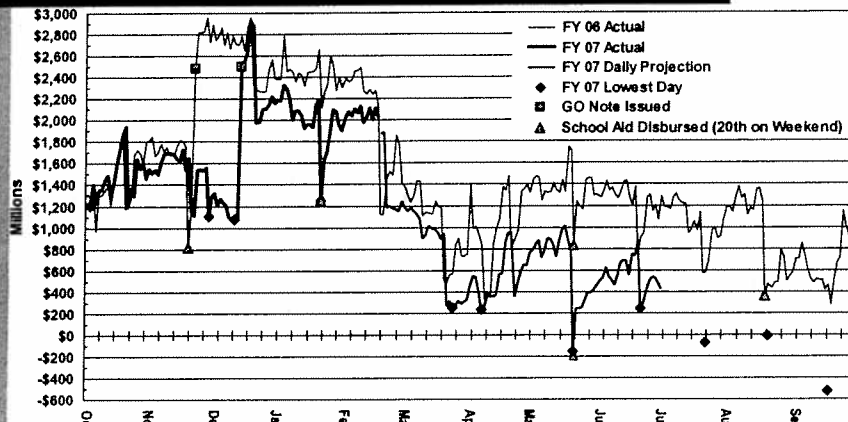
## Timing Issues

- The SBT replacement must be enacted rapidly to remove uncertainty for businesses to allow them to prepare
- The service tax needs to be enacted quickly to avoid mid-year cuts to education and vital services

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## Manageable Cash

FY 06 Actual & FY 07 Actual to Date and Projected



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Includes: GO Note proceeds of \$1.3 billion note borrowing, the GO Note repayment in September, and projected 21st Century Jobs Fund Disbursements. Does not include: proposed Tax Restructuring revenue.

## Manageable Cash Overview

FYE	Cash	Interest Income	G.O. Note	Manageable	CREDIT RATING		
30-Sep	GF/SAF/BSF	(Expense)	Borrowing	Cash	S&P	Moody's	Fitch
2000	\$ 2,896.0	\$ 137.3		\$ 4,892.1	AAA	Aa1	AA+
2001	2,085.7	115.0		3,868.2	AAA	Aaa	AA+
2002	599.9	5.7		2,376.2	AAA	Aaa	AA+
2003	(490.1)	(17.2)	\$ 1,248.0	1,425.7	AAA	Aaa	AA+
2004	(897.6)	(23.5)	1,300.0	1,179.6	AA+	Aa1	AA+
2005	(854.4)	(52.4)	1,275.0	1,018.9	AA	Aa2	AA
2006	(1,298.5)	(58.5)	1,299.5	860.8	AA	Aa2	AA
2007			1,306.9		AA *	Aa2 *	AA-

(in Millions)

\*negative outlook

- The cash balance has decreased by \$4.2 billion over the past 6 years. The BSF has been depleted.
- The cost of doing business has increased by \$216 million. The General Fund now pays interest instead of earning interest.
- External borrowing has been needed every year since 2003 to finance cash flow needs.
- The State's credit rating has decreased along with the cash deterioration. Note: Letter of Credit needed for Dec note borrowing.

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JENNIFER M. GRANHOLM  
GOVERNOR

STATE OF MICHIGAN  
DEPARTMENT OF TREASURY  
LANSING

ROBERT J. KLEINE  
STATE TREASURER

### **Taxation of Services under the Two - Penny Plan**

Governor Granholm has proposed a two percent tax on certain services as part of her comprehensive budget and economic plan for the 2007 and 2008 fiscal years. Under this proposal certain services would be taxed and others would not.

Included here is a description of those services that would be taxable and the number of other states that tax them; a description of those services that that would be *exempt* under the proposal; and a description of those *purchasers* that would be *exempt regardless of the service*.

The final list describes transactions sometimes considered services that are currently and would continue to be taxed under the 6 percent use tax, and would *not* be subject to the 2 percent tax.

It is important to note that other states that tax these services usually tax them at their sales tax rates, which typically range between 5 and 7%.

#### **Services that are Taxed**

<b>Service</b>	<b>Number of States that Tax</b>
<b>Transportation</b>	
Intrastate transportation of persons( non governmental)	12
Taxi operations	9
Intrastate courier	7
Limousine service	15
<b>Storage</b>	
Household, mini storage and cold storage	14
Automotive storage	20
Food storage	10
Fur storage	17
Marina service (docking , storage, cleaning and repair)	19
Packing and crating	11
<b>Finance , Insurance and Real Estate</b>	
Insurance services (excluding premiums)	7
Investment counseling	7
Real estate or personal property sales fees	6
Real estate management fees	6
Real estate title and abstract services	6

Service	Number of States that Tax
<b>Personal Services</b>	
Barber shops and beauty parlors	8
Pet grooming	19
Carpet and upholstery cleaning	19
Dating services	9
Debt counseling	8
Diaper service	24
Income from funeral services	15
Garment services (altering & repairing)	20
Gift and package wrapping service	22
Health clubs, tanning parlors, reducing salons	22
Laundry and dry cleaning services, coin-op	7
Laundry and dry cleaning services, non-coin op	24
Landscape services	21
Massage services	11
900 number services	29
Shoe repair	21
Swimming pool cleaning & maintenance	18
Tax return preparation	7
<b>Business Services</b>	
Advertising agency fees, excluding the medium	11
Armored car services	16
Bail bond fees	5
Debt collection	9
Credit information, credit bureaus	13
Employment agencies	11
Interior design and decorating	10
Maintenance and janitorial services	20
Lobbying and consulting	8
Marketing	7
Packing and crating	10
Exterminating	21
Private Investigation	15
Process server fees	7
Public relations, management consulting	8
Secretarial and court reporting services	9
Security services	17
Telemarketing services on contract	7
Telephone answering service	20
Temporary help agencies (fee net of wages paid by client)	12
Test laboratories (excluding medical)	9
Tire recapping and repairing	29
Travel agent fees	4
Window cleaning	19

Service	Number of States that Tax
<b>Automotive</b>	
Automotive washing and waxing.	22
Automotive road service and towing services	19
Auto service. except repairs, incl. painting & lube	25
Parking lots & garages	21
Automotive rust proofing & undercoating.	27
<b>Amusements</b>	
Pari-mutuel racing events.	29
Amusement park admission & rides	38
Billiard parlors	28
Bowling alleys	28
Cable TV services	26
Direct satellite TV	23
Circuses and fairs -- admission and games	35
Coin operated video games	19
Membership fees in private clubs.	24
Admission to cultural events or films where theater rental of the film is not taxed	34
Pinball and other mechanical amusements	20
Admission to professional sports events	38
<b>Professional Services</b>	
Accounting and bookkeeping	6
Architecture	6
Legal services	6
Engineering (other than research engineering)	6
Land surveying	8
Veterinary services	6
<b>Construction</b>	
General construction services	13
Carpentry, painting, plumbing and similar service	14
Grading and excavating	12
Water well drilling	11
<b>Repair and Fabrication</b>	
Custom fabrication labor	39
Repair labor, generally	25
Labor charges on repair of aircraft	20
Labor charges - repairs to interstate vessels	13
Labor charges - repairs to intrastate vessels	20
Labor - repairs to commercial fishing vessels	16
Labor charges on repairs to railroad rolling stock	12
Labor charges on repairs to motor vehicles	23
Labor on radio/TV repairs; other electronic equip.	25
Labor charges - repairs other tangible property	25
Labor - repairs or remodeling of real property	15
Labor charges on repairs delivered under warranty	8

<b>Service</b>	<b>Number of States that Tax</b>
Optional service contracts sold at the time of sale	30
Installation charges by persons selling property	24
Installation charges - other than seller of goods	19
Custom processing (on customer's property)	27
Custom meat slaughtering, cutting and wrapping	13
Welding labor (fabrication and repair)	32

### **Services that are Exempt**

#### **Health Care**

- Services of physicians
- Services of dentists
- Services of other health practitioners including chiropractors; optometrists; mental health practitioners; physical, occupational and speech therapists and audiologists; and podiatrists
- Outpatient care centers including family planning centers
- Outpatient mental health and substance abuse centers
- Other outpatient centers including HMO medical centers, kidney dialysis centers, and surgical and emergency centers
- Medical and diagnostic laboratories
- Home health care services
- Ambulance services
- Other ambulatory health care including blood and organ banks
- Hospitals including medical and surgical hospitals; psychiatric and substance abuse hospitals; and specialty hospitals
- Nursing care facilities
- Residential mental retardation, mental health, and substance abuse facilities
- Community care facilities for the elderly including homes for the elderly and other residential care facilities

#### **Social Assistance**

- Individual and family services including child and youth services, and services for the elderly and persons with disabilities
- Community food services
- Community housing services including temporary shelters, transitional housing to low-income individuals and families, volunteer construction or repair of low-cost housing, and repair of homes for the elderly or disabled
- Emergency and other relief services
- Vocational rehabilitation services including job counseling, job training, and training and employment to persons with disabilities
- Child day care services

#### **Other Exempt Services**

- Educational services, including personal lessons
- Services performed or provided by a nonprofit school or nonprofit educational institution to students grade 12 or below
- Services performed or provided by a church, hospital, parent cooperative preschool, or nonprofit organization (exempt under sections 501(c)(3) or 501(c)(4) of the Internal Revenue Code), up to a total amount of \$5,000 in a calendar year

- Wired telecommunications services
- Wireless telecommunications services
- Accommodations and rental housing
- Water and sewer systems
- Air transportation
- Water transportation of freight and passengers, except scenic transportation
- Pipeline transportation
- Publishing and broadcasting, except cable television and satellite television subscriptions, an exemption that would include the purchase of advertising media such as television or radio time, print or billboards.
- Motion pictures, except for admissions to motion picture or video exhibitions
- Sound recording
- Internet service providers, Web search portals, data processing services, and other information services – Includes access to the Internet; Internet search facilities; transforming, preparing, or placing data for dissemination on the Internet for others. Also includes the use of shared computer resources, news syndicates, libraries, and archives.
- Services provided as part of a live entertainment event such as the services provided by promoters; agents and managers; and independent artists, writers, and performers
- Admissions to museums, historical sites, parks, and zoos
- Gambling industry services
- Leasing real property, including residential buildings and dwellings, non-residential buildings, and other real property
- Rail and truck transport
- Religious, grant making, and civic services, including religious organizations; grant making foundations and charitable trusts; social advocacy organizations; civic and social organizations; and business, professional, labor, and political organizations
- Computer systems design includes writing, modifying, testing, and supporting software to meet the needs of a particular customer; planning and designing computer systems that integrate computer hardware, software, and communication technologies; and on-site management and operation of clients' computer systems and/or data processing facilities
- Scientific research and development including conducting original investigation undertaken on a systematic basis to gain new knowledge (research) and/or the application of research findings or other scientific knowledge for the creation of new or significantly improved products or processes (experimental development). This includes research in the physical, engineering, life, and social sciences and the humanities.
- Finance and insurance services including most activities of banks and credit unions; most activities of nonbank credit institutions (mortgage lenders and credit card companies); securities and commodity brokerage and management; and activities of pension funds, health and welfare funds, insurance funds, and investment pools. The following finance and insurance services are not exempt and would be subject to tax: i) insurance agency and brokerage services; ii) claims adjusting services; iii) third-party insurance administration services; and iv) investment advice.

**Purchasers for whom the Provision of a Service is NOT Taxed**

- Farmers as part of the farming operation
- Manufacturers for direct use in manufacturing
- Governmental entities including the American Red Cross

- Intermediaries who purchase a service for a third party and the third party is the ultimate consumer of the service (resale of the same service)
- Regularly organized church or house of worship, excluding a service consumed as part of a commercial enterprise
- Extractors for direct use in an extractive operation
- Nonprofit school, nonprofit hospital, nonprofit home for children or aged persons operated by a governmental entity, religious, or fraternal organization, veterans' organization, or corporation, if the operation benefits the public at large
- Nonprofit organizations exempt under sections 501(c)(3) and 501(c)(4) of the Internal Revenue Code, to the extent the service allows the organization to carry out its purpose

**Transactions Currently Taxed under the 6% Use Tax and not Subject to the 2 Percent Tax**

- Typesetting; plate making
- Intrastate telephone and telegraph (business and residential)
- Interstate telephone and telegraph, based on origin and billing address (business and residential)
- Cellular phone (business and individual)
- Natural gas for business use
- Other fuel (including heating oil) for business use
- Electricity
- Natural gas for residential use (4 % rate )
- Other fuel, including heating oil for residential use (4% rate)
- Tuxedo rental
- Water softening
- Commercial art and graphic design
- Commercial linen supply
- Photocopying
- Photo finishing
- Printing
- Sign construction and installation
- Software- packaged or canned program
- Material for custom software programs
- Video rental
- Short term property rental (such as carpet cleaners or lawn equipment)
- Rental of bulldozers and other heavy equipment
- Short term auto rental
- Long term auto leasing
- Aircraft rental to individual pilots both short and long term.
- Hotel and motel for less than 30 consecutive days
- Repair material
- Taxidermy